No. 14402

In the United States Court of Appeals for the Ninth Circuit

OTIS A. KITTLE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 5-26) are reported at 21 T. C. 79.

JURISDICTION

This appeal involves the liability for federal income taxes for the calendar year 1945 of a taxpayer residing at Bishop, California, who filed his returns for the year in question with the Collector of Internal Revenue for the District of Nevada. The statutory notice of deficiency was mailed to the taxpayer on March 28, 1951. (R. 27.) Within ninety days thereafter, on June 25, 1951, he filed a petition for redetermination with the

Tax Court, pursuant to Section 272 of the Internal Revenue Code of 1939. (R. 3.) Thereafter, on January 28, 1954, the Tax Court entered its decision. (R. 26.) The petition for review by this Court of the Tax Court's decision was filed on April 22, 1954. (R. 35-36.) Jurisdiction is conferred upon this Court by Section 7482(a) of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court was correct in holding that amounts received by the taxpayer in 1947 as payments under a lease of iron ore lands were royalties, taxable as ordinary income, and not proceeds from the sale of ore in place, constituting capital gains, thus diminishing the amount of the net operating loss for that year which the taxpayer is entitled to carry back to the taxable year 1945.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set forth in the Appendix, *infra.*

STATEMENT

The pertinent facts, substantially as found by the Tax Court (R. 6-8) and referred to in its opinion (R. 17-21), are as follows:

The taxpayer is an individual residing in Bishop, California. On January 1, 1946, he owned a 1/63 interest in the mineral rights appurtenant to certain Minnesota iron ore properties commonly known as the "Rust Mine Lands." For many years prior to January 1, 1946, these iron ore properties were operated by Oliver Iron Mining Company, a corporation, as assignee of Lake Superior Consolidated Iron Mines, a corporation, as lessee, under a lease dated October 2, 1899, naming the taxpayer's predecessors in interest and certain others as lessors. (R. 6, 7.)

The taxpayer and the other owners of percentage fee interests in the iron ore properties, as lessors, entered into an amended lease, as of January 1, 1946, whereby they leased the "Rust Mine Lands" for a term of fifty years thereafter to the Oliver Iron Mining Company, as lessee, for the purpose of its conducting mining operations thereon. (R. 7, 18-19.) The amended lease, in pertinent part, provided as follows (R. 7, 19-21):

> 5. The Lessee hereby covenants and agrees to pay to the Lessors a royalty on all iron ore mined and shipped from the Rust Mine Lands while this lease shall remain in force, as follows:
>
> 6. Upon the first twenty million (20,000,000) tons of iron ore mined and shipped by the Lessee from the Rust Mine Lands the royalty shall be at the rate of fifty (50) cents for each gross ton of 2240 pounds avoirdupois.
>
> * * * * *
>
> 9. The Lessee further covenants and agrees that for each year prior to January 1, 1966, it will pay to the Lessors the sum of Five Hundred Thousand Dollars ($500,000.00), payable quarterly on the twenty-fifth days of April, July, October and January in each year, irrespective of the quantity of iron ore actually shipped from the Rust Mine Lands during such year or any quarter thereof, and the total amount so paid, including the final payment on January 25, 1966, shall satisfy the royalty of

fifty (50) cents per ton on the first twenty million (20,000,000) tons of ore shipped from the Rust Mine Lands.

10. If, prior to January 1, 1966, less than twenty million (20,000,000) tons of ore shall have been shipped from the Rust Mine Lands, the balance of said twenty million (20,000,000) tons of ore, upon which the royalty shall have been paid as shown above provided, on or before January 25, 1966, may be shipped, without further payment of royalty thereon, at any time thereafter during the existence of this lease; but the shipment thereof shall not be taken to satisfy or affect in any way the minimum requirements after January 1, 1966, hereinafter provided for.

11. If, prior to January 1, 1966, the Lessee shall ship, as it may, more than twenty million (20,000,000) tons of iron ore from the Rust Mine Lands, the Lessee shall pay to the Lessors, in addition to the quarterly payment to be made as aforesaid, the base royalty on all such ore in excess of the said twenty million (20,000,000) tons shipped during each quarter year, payable on the twenty-fifth day of the month following the end of such quarter; and the excess royalty, if any, thereon, shall be paid on the twenty-fifth day of July of the year following the year in which such ore was shipped.

* * * * *

47. Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore thereto-

fore mined, or to continue in possession of the Rust Mine Lands, any unpaid balance of the total amount of Ten Million Dollars ($10,000,000) payable as royalty on twenty million (20,000,000) tons of ore as aforesaid, shall nevertheless be paid by the Lessee to the Lessors in quarterly installments of One Hundred Twenty-five Thousand Dollars ($125,000.00) each, on the 25th days of April, July, October and January in each year, until said amount is fully paid; and for an adequate consideration such obligation is hereby assumed and agreed to be paid as a continuing corporate obligation of said Lessee.

* * * * *

During the calendar year 1947 the taxpayer received from Oliver Iron Mining Company amounts which aggregated $7,936.52, representing his undivided interest in the quarter annual payments under the amended lease. The taxpayer's undepleted cost attributable to these payments was $969.40, and he paid or incurred expenses in connection with the payments totaling $424.54. (R. 8.) He filed his return for the calendar year 1945 with the Collector of Internal Revenue for the District of Nevada, and thereafter filed an amended income tax return for that year, claiming a net operating loss deduction of $8,912.05, the claimed deduction being attributable to a net operating loss carry-back from the calendar year 1947. (R. 6-7.) In his return for 1947 the taxpayer treated the payments received in that year from the Oliver Iron Mining Company under the amended lease of January 1, 1946, as gain from the sale of a capital asset, instead of as royalties, thus reflecting for that year, and carrying back to 1945, a larger net operating loss than the Commissioner deemed proper. The Commissioner determined a deficiency against the taxpayer in the amount of $160.71 for the calendar year 1945. (R. 6.) The taxpayer petitioned the Tax Court for a redetermination. (R. 3.) The Tax Court sustained the Commissioner on this issue and entered its decision accordingly (R. 25-26), from which the taxpayer brings the instant appeal (R. 35-37).

SUMMARY OF ARGUMENT

The Tax Court properly concluded that the January 1, 1946, agreement with the Oliver Iron Mining Company was a mining lease under which the taxpayer retained an economic interest, and not a sale of iron ore in place. Not only is the agreement termed an "Amended Lease" and couched in consistent terminology throughout, but the substance of its provisions testifies fully to the accurateness of its entitlement. The fundamental difference between a mining lease and a conveyance in sale of minerals in place is that the predominating purpose of the former is to secure the exploitation and development of property, and it merely conveys privileges directed to that end. The grant in the instant agreement is a limited one for the purpose of exploring for, mining, taking out, and shipping merchantable iron ore from the Rust Mine Lands, which clearly characterizes it as a mining lease and not a conveyance of minerals. It has been decisively settled that the retention by a lessor of a right to royalties constitutes an economic interest in the minerals in place, rendering the proceeds from the production of the minerals ordinary income and entitling him to a depletion deduction. Here the taxpayer retained a royalty on all iron ore mined and shipped during the term of the amended lease.

The taxpayer points to the provisions in the agreement requiring the lessee to pay the minimum sum of $500,000 per year during the first twenty years of the lease, regardless of the amount of iron ore actually shipped from the premises during any year, in satisfaction of royalties of 50 cents per ton on the first 20,000,000 tons of ore shipped, and despite any termination of the lease foreclosing the rights of the lessee thereunder. His position that as a consequence of these provisions there was a transfer of his economic interest in 20,000,000 tons of iron ore in place to the lessee upon the execution of the agreement, is without merit. The possibility under the agreement that the lessee, though he must pay the royalties on the first 20,000,000 tons of ore in any event, may nevertheless not be entitled to the ore because of a termination of the agreement, is totally inconsistent with any suggestion that the taxpayer sold and conveyed all his economic interest to the lessee.

In addition to the fact that the payments involved here are royalties at a specified rate of 50 cents per ton, the amended lease provides that if the lessee has not mined and shipped the minimum of 20,000,000 tons of ore within the first 20 years, it may take the remaining tonnage during the life of the lease without further royalties, but additional royalties are prescribed for ore taken in excess of the minimum tonnage. It is evident, therefore, that these royalty payments were intended to be measured by production in the ordinary course of mining operations under the amended lease, and the requirement that royalties be paid upon the minimum tonnage in all events is merely a provision for minimum royalties. This is a feature commonly found in mining leases which, it is clear from the cases involving such leases, does not convert what would otherwise be a mining lease into a sale of ore in place. Moreover, as the lower court pointed out, the provision for minimum royalties is in principle the same thing as a provision for advance royalties or cash bonus payments which, it has been decisively settled, are, like royalties, consideration for the lease taxable as ordinary income to the lessor, and not capital gains. The Tax Court, therefore, was correct in regarding the payments here involved as ordinary income for the purpose of computing the taxpayer's net operating loss for the year 1947 and the resulting carry-back deduction allowable for the taxable year 1945.

ARGUMENT

The Tax Court Was Correct in Holding That the Amounts Received by the Taxpayer in 1947 as Payments Under the Amended Lease of the Rust Mine Lands Were Royalties Taxable as Ordinary Income, and Not Capital Gains

The vital question presented on this appeal is whether the amounts received by the taxpayer in 1947 under the amended lease entered into as of January 1, 1946, with the Oliver Iron Mining Company constituted royalties received pursuant to a mining lease under the terms of which the taxpayer retained an economic interest, as the Tax Court held (R. 22-23), or proceeds from the sale of minerals in place, as the taxpayer contends (Br. 6-7). If they were royalties, the amounts constituted ordinary income, but if they were proceeds from the sale of a capital asset, they constituted long-term capital gains. Treatment of the amounts as ordinary income results in the taxpayer's having a smaller net operating loss for the taxable year 1947 available for carry-back to the taxable year 1945 than if such amounts are treated as long-term capital gains. Section 122(a), Internal Revenue Code of 1939 (Appendix, *infra*). Consequently, the net operating loss deduction for 1945 allowable to the taxpayer under Section 23(s) of the 1939 Code (Appendix, *infra*) is smaller than the amount to which he claims to be entitled.

It should be noted at the outset that the same considerations determine both to whom income derived from the production of minerals is taxable and to whom a deduction for depletion is allowable. *Anderson* v. *Helvering,* 310 U.S. 404, 407. It follows that one who has an economic interest in minerals requiring him to treat the income from production as ordinary income is entitled to recover his investment through a deduction for depletion. On the other hand, one who has divested himself of any economic interest through a sale retains no depletable economic interest. See Section 23 (m), Internal Revenue Code of 1939, and Section 29.23(m)-1, Treasury Regulations 111 (both Appendix, *infra*).

It is clear from a consideration of the terms of the agreement of January 1, 1946, between the taxpayer and the Oliver Iron Mining Company that the Tax Court was amply warranted in considering that agreement as a mining lease rather than a sale, and therefore the payments made to the taxpayer in 1947 under that agreement were properly held to be royalties rather than capital gains. To begin with, the agreement is entitled "Amended Lease" (R. 17, 33), and the terminology employed by the parties throughout is wholly consistent therewith. Of course, the name used by the parties in describing the contract does not necessarily determine its nature. *Hamme* v. *Commissioner,* 209 F. 2d. 29, 32 (C.A. 4th), and cases there cited, certiorari denied, 347 U.S. 954. However, in the instant case, the substantial provisions of the agreement fully indicate the correctness of its entitlement. As the Tax Court indicated in *West* v. *Commissioner,* 3 T.C. 431, 453, affirmed, 150 F. 2d 723 (C.A. 5th), certiorari denied, 326 U.S. 795, rehearing denied, 327 U.S. 815, and 328 U.S. 877 and 881, the most essential difference between a lease and a conveyance of minerals is that the predominating purpose of a lease is to secure the exploitation and development of property for the purposes set out in the transferring instrument. The significant and inescapable fact is that the express purpose of the agreement under consideration clearly indicates that it is a lease and contains no provisions which characterizes it as a sale. Thus, as stated in the agreement, the *lease* of the Rust Mine Lands is a limited one "for the purpose of exploring for mining, taking out and shipping therefrom the merchantable iron ore (as well as other minerals as hereinafter provided for) which is or hereafter may be found on, in or under the Rust Mine Lands". (R. 19.) Directly apropos, in the light of the purpose thus expressed, is *Burnet* v. *Harmel,* 287 U.S. 103, 107, wherein the Supreme Court stated:

> Moreover, the statute speaks of a "sale," and these leases would not generally be described as a "sale" of the mineral content of the soil, using the term either in its technical sense or as it is com-

monly understood. Nor would the payments made by lessee to lessor generally be denominated the purchase price of the oil and gas. By virtue of the lease, the lessee acquires the privilege of exploiting the land for the production of oil and gas for a prescribed period; he may explore, drill, and produce oil and gas if found. Such operations with respect to a mine have been said to resemble a manufacturing business carried on by the use of the soil, to which the passing title of the minerals is but an incident, rather than a sale of the land or of any interest in it or in its mineral content. *Stratton's Independence* v. *Howbert,* 231 U.S. 399, 414, 415; see *Von Baumbach* v. *Sargent Land Co.,* 242 U.S. 503, 521.

Certainly, the amended lease contains no expression whatever indicating any intent by the parties that the taxpayer convey any part of his fee interest in the Rust Mine Lands beyond the mere granting of mining privileges. Moreover, irrespective of legal ownership, it is quite clear that the taxpayer retained an economic interest since he specifically retained (R. 19, 22) "a royalty on *all* iron ore mined and shipped from the Rust Mine Lands" while the amended lease should remain in force. (Italics supplied.) It is settled that the retention of a right to royalties constitutes an economic interest in the minerals in place. *Palmer* v. *Bender,* 287 U.S. 551, 558. Indeed, it is decisively established that a reservation of even a much less direct interest than the right to royalties constitutes the retention of an economic interest in minerals in place. In *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, which involved the payment of royalties, a bonus and percentage of net profits, it was held that all these payments were subject to depletion and that the right to even net profits constituted an economic interest. This holding was further expanded upon by *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, in which it was held that the right to a share in net profits, even without royalties or bonuses, constitutes an economic interest.

The taxpayer's position, as the Tax Court noted (R. 22), is based upon a consideration solely of paragraphs 9 and 47 of the amended lease, divorcing those paragraphs from the context and so conveniently ignoring other limiting provisions of the agreement which so plainly reveal it to be a lease of mining rights and not an instrument of sale. Paragraph 9 provides that the lessee pay the lessors $500,000 each year during the first 20 years of the lease, regardless of the amount of iron ore actually shipped from the Rust Mine Lands during any year, such payments to be in satisfaction of "the royalty of fifty (50) cents per ton on the first twenty million (20,000,000) tons of ore shipped from the Rust Mine Lands." (R. 20.) Paragraph 47 requires that the lessee pay any unpaid balance of the total of $10,000,000 payable as royalty on 20,000,000 tons of ore, by payments in the amounts and at the times specified in the amended lease, "Notwithstanding any termination of this lease, including the termination of the right of the Lessee thereafter to mine any ore from the Rust Mine Lands, or to ship therefrom any ore theretofore mined, or to continue in possession of the Rust Mine Lands". (R. 21.)

The taxpayer apparently takes the position that these provisions provide for a sale of his interest in

20,000,000 tons of iron ore in place to the Oliver Mining Company. We believe that, without more, paragraph 47 completely belies the taxpayer's claim that (Br. 7) "As to the first twenty million tons * * * [his] economic interest * * * passed to the purchaser upon the execution of the agreement." That paragraph discloses that, while the lessee is required to pay royalties on 20,000,000 tons of ore, nevertheless there exists a distinct possibility under the agreement that in the event of termination of the lease the lessee might never be able to get all or a part of the ore. This is wholly inconsistent with any suggestion that there was a transfer of taxpayer's "economic interest" in such ore, but, to the contrary, is plainly indicative of the actualities, namely, that the agreement, as it purports to be, is merely a lease of mining rights, and not a sale of minerals.

Furthermore, it is perfectly clear that the payments here sought to be treated as gain from a sale were intended by the parties, in the ordinary course of mining under the lease, to be measured by the production and shipment of ore. Paragraph 6 of the amended lease specifically provides for a royalty at the rate of fifty cents per gross ton upon the first 20,000,000 tons of ore mined and shipped from the Rust Mine Lands, and paragraphs 10 and 11 provide that in the event of the mining and shipment of less than 20,000,000 tons of ore during the first twenty years of the lease, the balance of that tonnage may be taken without further payment of royalties during the life of the amended lease, and additional royalties must be paid upon any excess over that tonnage at a specified rate. (R. 19, 20.) Viewed in the light of these provisions, it is clear beyond controversy that the requirement of the payment of prescribed royalties upon the first 20,000,000 tons of ore in all events, whether or not such tonnage is actually mined and shipped, is nothing more or less than a provision for minimum royalties, as the Tax Court correctly concluded. (R. 23.)

It is appropriate to observe here that, as the taxpayer points out (Br. 16), this "Amended Lease" is in the nature of a renewal of a prior mining lease entered into in 1899 for a term of fifty years upon the same iron ore properties. (See Ex. A.)[1] As the Tax Court noted (R. 17), the 1899 lease was considered in the case of *DeVelin* v. *Commissioner,* 22 B.T.A. 1400, 1405, wherein it was held that payments under the lease were royalties, constituting ordinary income, and not the proceeds of a sale of any part of the land or other capital assets. The taxpayer fails to point out any significant departure, in the amended lease, from the 1899 lease which would call for a different result here. All of the limiting features which so clearly denominate the agreement under consideration a mining lease and not a sale were present in the 1899 agreement, and the 1899 lease also contained a provision for minimum royalties. (R. 31-33; Ex. A.) The amended provision for minimum royalties, upon which the taxpayer relies, thus merely represents a change in degree, not in kind.

A provision for the payment of minimum royalties in mining leases is a circumstance which frequently has

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[1] This exhibit, except for the brief portion included in the record (pp. 31-33), along with a considerable part of the provisions of the "Amended Lease" here involved, was not printed in the interest of minimizing the size of the printed record, the parties having stipulated (R. 38-39) that the unprinted portions of these exhibits may be considered in their original form.

been present in the litigated cases, the decisions in which negative any suggestion that the inclusion of such a provision suffices to convert a lease of mining rights into an agreement of sale. Thus, in *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, the Supreme Court dealt with mining leases which provided for the exploring for, mining and removing of merchantable ore which might be found on the leased premises during the periods named, usually fifty years, in which the lessees agreed to mine and ship a certain specified minimum quantity of ore at a specified royalty, which minimum royalty was payable in any event, as is the case here. The question arose whether the moneys received by the landowners under the leases constituted gross income, or whether they represented, in whole or in part, the conversion of the investment of the owners from ore into money. The Court held that the leases in question were not equivalent to the sales of property and that the moneys paid by the lessees to the owners were not converted to capital but were rents and royalties and, as such, were income properly included in computing their taxes under the applicable corporation tax law.[2] In *United States* v. *Biwabik Mining Co.,* 247 U.S. 116, the Supreme Court had before it a lease for a term of fifty years and three months to explore for, mine, and remove the merchantable iron ore which might be found upon the lands involved for a specified royalty per ton. The lessee agreed to remove at least 300,000 tons of ore annually and the specified royalty was payable in any event. The deposit of the ore on

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[2] It is noted that the Court cited with approval (p. 518) decisions of the Supreme Court of Minnesota expressly denying the conclusion that such leases were merely conveyances of the ore in place.

the leased premises was of such character that its quality and quantity were capable of determination with extraordinary accuracy by drilling and shafts. The Court held that the lease involved was not a conveyance of the ore in place, notwithstanding the fact that it could be measured with substantial accuracy, but was a grant of the privilege of entering upon, discovering, and developing and removing the minerals from the land, and that the lessor's receipts constituted ordinary income subject to taxation under the applicable corporation tax Act, and not capital gains.

Likewise, *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, involved mining leases of iron ore lands containing minimum royalty provisions. The Court held (p. 371) that the leases involved did not constitute a conveyance of ore in place.[3] There was also a provision for the payment of minimum royalties in the mining lease involved in *Bankers Coal Co.* v. *Burnet,* 287 U. S. 308, in which it was held that the royalties received by the lessor did not constitute payments for capital assets. Recently, the Fourth Circuit in *Hamme* v. *Commissioner,* 209 F. 2d 29, certiorari denied, 347 U. S. 954, which involved mining leases similarly providing for (p. 31) "A minimum of $10,000 in royalties * * * to be paid in every six months regardless of sales", stated (pp. 34-35):

> The minimum requirement was a minimum payment of royalties under the contract, derived from

[3] This case involved the question whether the lessee was nevertheless entitled to a depletion allowance in determining its income under Section 12(a) of the Revenue Act of 1916, c. 463, 39 Stat. 756. The Court held, notwithstanding that there was no conveyance of ore in place, that the lessee was entitled to the allowance of depletion upon its interest.

mining operations, and obviously compelled Haile Mines to exploit the minerals on penalty of default and loss of the entire property. It is clear that the impelling motive in the negotiations was the development and operation of potentially productive tungsten properties which petitioners themselves were financially unable to develop. Under such circumstances, we can only agree with the Tax Court that the provisions of this agreement weigh heavily in favor of a leasing arrangement, *West* v. *Commissioner,* 5 Cir., 150 F. 2d 723, and payments received thereunder were normal income.

Moreover, it is perfectly evident that the provision for minimum royalties involved here is, in principle, precisely the same as the provision for advanced royalties or cash bonus payments involved in *Burnet* v. *Harmel,* 287 U. S. 103; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; and *Bankers Coal Co.* v. *Burnet, supra,* as the Tax Court pointed out. (R. 23.) In rejecting arguments similar to those advanced by the taxpayer here, the Court stated in *Burnet* v. *Harmel, supra* (pp. 111, 112):

> * * * the payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose of exploiting it, as well as for the ownership of the oil and gas; under both the bonus payments are paid and retained, regardless of whether oil or gas is found and despite the fact that all which is not abstracted will remain the property of the lessor upon termination of the lease.
>
> * * * * *

> Bonus and royalties are both consideration for the lease and are income of the lessor. We cannot say that such payments by the lessee to the lessor, to be retained by him regardless of the production of any oil or gas, are any more to be taxed as capital gains than royalties which are measured by the actual production. * * *

It is submitted that the foregoing decisions are dispositive of the issue which the taxpayer brings here.

The taxpayer offers ~~on~~ no authority to sustain his contentions. His heavy reliance (Br. 9-13) upon *Anderson* v. *Helvering,* 310 U. S. 404, is misplaced, since that case is inapplicable here for the reason that it involved an outright sale and conveyance of oil properties, including the fee interest, for a specified money consideration. The Court there held that the seller of the properties, who was seeking a depletion allowance upon the payments of the purchase price, had retained no economic interest measured by production, the amount payable to him being fixed without reference to the amount of the production of oil and with the possibility that it might be satisfied in full from the proceeds derived through a sale by the purchaser of the properties which were conveyed in fee. Similarly, in *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, cited by the taxpayer (Br. 14-16), there was an absolute sale divesting the taxpayer of all economic interest in oil properties, as a consequence of which he was denied any depletion deduction. Likewise, *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603, referred to by the taxpayer (Br. 13-14) lends no support to his position.

With respect to the taxpayer's arguments based upon various suppositions and hypotheses (Br. 8-9) under which he urges that a sale rather than a lease would result, it is sufficient, without entering into useless controversies as to the correctness of his assumptions, merely to point out that what he "*could* or *could not* grant does not control the nature of what he *did* grant." *Burkett* v. *Commissioner,* 31 F. 2d 667, 668-669 (C.A. 8th), certiorari denied, 280 U. S. 565. It is unequivocally clear here that the taxpayer merely granted a lease of mining rights and not a conveyance in sale of minerals, as the Tax Court properly determined.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APRIL, 1955.

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

* * * * *

(s) [As added by Sec. 211 (a), Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122. (26 U. S. C. 1952 ed., Sec. 23.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [As amended by Sec. 150(a)(1), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(26 U. S. C. 1952 ed., Sec. 117.)

SEC. 122 [As added by Sec. 211(b), Revenue Act of 1939, *supra,* and amended by Sec. 105(e)(3)(A), Revenue Act of 1942, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

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(26 U. S. C. 1952 ed., Sec. 122.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Timber; Depreciation of Improvements.*—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

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